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No. 83-A-484

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In the Supreme Court of the United States

October Term, 1983

KEWANEE OIL COMPANY,
Petitioner,

vs.

BARBARA HOLMES, EXECUTOR OF THE ESTATE OF ELMER HOLMES; EVELYN WOLKINS; SAM BAIER and BONNIE BAIER, His Wife; JAMES H. TRICE, JR., TRUSTEE; and LaVON THOMPSON HOEFLE,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court, State of Kansas

BRIEF OF RESPONDENTS IN OPPOSITION

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Date: February, 1984

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QUESTION PRESENTED

There is no federal question presented in the Petition for Certiorari. Gulf states the federal question is whether or not the Supreme Court of Kansas may ignore the limitations the Natural Gas Policy Act places on prices the purchaser may pay the producer, and, therefore, the producer may not pay its royalty owners in excess of NGPA prices for old gas, even though "stripper gas" and "new gas" are being sold for higher prices pursuant to NGPA. Respondents believe the only question in this case is lease interpretation and application of "prevailing market rate" to royalties payable, and that no federal question is involved.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Other

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ON PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT, STATE OF KANSAS

BRIEF OF RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the Supreme Court of Kansas which this court is asked to review is as attached to the Petition for Certiorari, *Holmes, et al. v. Kewanee Oil Co.*, 223 Kan. 554, 664 P.2d 1335 (1983), Appendix 1a-13a. Memorandum decision of the trial court is at Petition Appendix 19a-31a.

NATURE OF THE CASE

Judgment was awarded the six plaintiffs, Barber County, Kansas, royalty owners, by the trial court, amounting to the difference between their royalties for natural gas computed and paid during the five years preceding the filing of the action, based on 1/8th of the proceeds of sale, and the royalties based on 1/8th of the market value of the gas. The Supreme Court of Kansas affirmed.

In addition, the trial court allowed and the Supreme Court affirmed the difference in royalty owners' proceeds of gas sold and market value of the gas sold since filing of the actions.

Gulf questions only the judgment as to the difference in royalties paid and market value since December 1, 1978, the effective date of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. Section 3301 et seq. (Petition for Cert., i, Question Presented.)

The Kansas Supreme Court did not as stated by Gulf, Petition for Cert., page 4, reverse the trial court's grant of prospective relief based on the Section 108 price until deregulation in 1985, but said that the market value finding was "factual in nature and not controlling on future cases because the market might fluctuate." (Petition for Cert., Appendix 12a.) The Kansas Supreme Court did say that future royalties should be based on the highest and best price paid for gas in Barber County, Kansas, whether or not that is the Section 108 stripper price, and with this respondents agree.

STATEMENT OF THE CASE

Kewanee Oil Company being a wholly owned subsidiary of Gulf Oil Corporation, which is a wholly owned subsidiary of Gulf Corporation (Petition for Cert., page 2), petitioner will be hereinafter referred to as "Gulf".

Gulf is the successor to lessees under certain oil and gas leases covering Barber County, Kansas, land, most of which were made in 1936 and 1937 by plaintiffs' predecessors in title. (Petition for Cert., Appendix 20a-22a.) The leases have been perpetuated by production.

Respondents are six (6) individual royalty owners, successors to the original oil and gas lessors.

There were extensive findings of fact and conclusions of law made by the trial court (Appendix to Petition, 19a-31a), all of which were affirmed by the Supreme Court of Kansas, excepting findings and conclusions pertaining to prospective relief, which were modified to the highest and best price paid for gas in the Medicine Lodge area, whether or not stripper price. (See Petition for Cert., Appendix 12a.)

REASONS FOR NOT GRANTING THE WRIT

1. The decision of the Kansas Supreme Court is thorough and thoughtful. However, nowhere does it say, as claimed by Gulf, that Section 108 "stripper price" is determined to be the market value. On the contrary, it says that the highest and best price paid in the Medicine Lodge area is the market value, whether or not that is the Section 108 stripper price. (See Appendix to this brief, excerpts from Kansas Supreme Court opinion as to reasons for affirming trial court's decision, Appendix 1a-2a.)

There is no federal question here, but only the question of interpretation of oil and gas leases and application of the "prevailing market rate" to royalties for which royalty owners were entitled under the leases.

2. Gulf admits:

> "Natural gas leases and sales contracts are, of course, to a large extent creatures of state law, to be interpreted according to state law. (Citing cases.)" (Petition for Cert., page 10.)

Gulf further admits that according to *Mobil Oil Corp. v. FPC,* 463 F.2d 256 (D. C. Cir. 1971):

> ". . . royalty owners were not subject to the FPC's jurisdiction under the Natural Gas Act." (Petition for Cert., page 15.)

Neither does the Natural Gas Policy of 1978 apply to royalty owners. (See FERC letter opinion of August 2, 1979, hereto attached at Appendix 3a.) No "sale" was made by royalty owners in *Mobil v. FPC,* supra, nor was any "sale" made by royalty owners under NGPA. Therefore, terms of neither of those acts apply to payments to be made by producers to royalty owners.

3. Federal law does not as stated by Gulf (Petition, pages 9-10) conflict with the Kansas Supreme Court opinion.

These six royalty owners have made no sale of gas. All of the gas belonged to Gulf. Gulf had the exclusive right under the leases to produce and sell the gas. Royalty owners or landowners are not parties to any gas sales contracts. Whatever price Gulf gets for the gas is up to Gulf and KP&L, the purchaser.

Gulf is obligated under the lease contracts to pay its royalty owners 1/8th of "gross proceeds at the prevailing

market rate." This it has not done and will not do until it pays the judgment allowed - as G•.f says (Pet., p. 9), about "half again" more royalty for the period 1974 on up to date - market value having averaged about 3/16ths of proceeds of sale rather than 1/8th. (See also Pet. App. 29a.)

4. Gulf contends the rate it is permitted by federal regulation to charge puts a ceiling on its royalty obligations. Actually, the process begins at the other end. Royalties to be paid should first be determined according to the lease terms and state law. Under Kansas law, the lessee acquires no interest in the land nor in the gas until it is produced. It acquires, under the lease, the license to produce the gas. It then owns the gas and has the right to sell it. What Gulf pays the royalty owners, in royalties, for the right to produce and sell should be no more concern of the rate makers than cost of pipe and equipment or wages for operating the lease. (See Summers Oil & Gas, Permanent Edition, Volume IA, Section 161; and *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, cert. denied, 439 U.S. 1127.)

5. The following cases cited by Gulf dealt with producer - purchaser contracts for sale of gas - not the interpretation of oil and gas lease contracts for royalty payments:

Arkansas Louisiana Gas Co. v. Hall, 453 U. S. 571 (1981);

California v. Southland Royalty Co., 436 U. S. 519 (1978); and

Northern Natural Gas Co. v. Kansas State Corporation Comm., 372 U. S. 84 (1963).

The Kansas Supreme Court *Matzen* case (Petition for Cert., page 13) is not in any way related to this case, nor was there much similarity in the evidence in trial court. Certainly the hypothetical comparison of rates on Petition, page 14, Note 7, has no bearing on the facts or law applicable in this case.

The recent case of *FERC v. Pennzoil Producing Co.*, 439 U. S. 508, does not support Gulf's position that construction of market value royalty clauses in leases was a matter of federal law. On the contrary, this court cited *Lightcap,* supra, and further held that "all that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level." (*FERC v. Pennzoil,* supra, page 519.)

6. In October, 1981, the Gulf (Kewanee) - KP&L contract price was $2.08 per million btu's (per 1,000 cubic feet) as compared to $3.116 paid on Medicine Lodge area stripper well gas - half again as much. (Petition for Cert., page 9.) This would mean a royalty payment of 3/16ths rather than 1/8th - a royalty amount for which most new leases in the area are being written - hardly confiscatory as argued by Gulf. (Petition, page 14.) After more than 40 years production while paying a royalty of only 1/8th of contract proceeds, Gulf can now well afford to pay a 3/16ths royalty. Cost of their wells now has been paid many times over.

7. The Kansas Supreme Court was not ruling what the purchase price should be under the contract, but what amount of royalty the producer should pay under terms of the leases.

The judgment is not a windfall for the lessors, but payment to which they are entitled under the plain, simple and specific terms of the leases.

The Kansas Supreme Court opinion ruling does not affect the gas purchase contract but only the proportion of the amount of gas sales that goes to the royalty owners.

There was no ruling on federal law or the purchase price of gas but only a ruling as to the amount of royalties payable under terms of the leases.

8. Gulf argues that Kansas stands alone in holding that market value royalty payments may exceed federally regulated contract gas prices. Not so. Both Montana and Texas, substantial gas producing states, stand with Kansas. (*Montana Power Co. v. Kravik,* 586 P.2d 298 (Montana 1978); *Texas Oil & Gas Corp. v. Vela,* 429 S.W. 2d 866 (Texas 1968); *Foster v. Atlantic Refining Co.,* 329 F.2d 485 (5th Cir. 1964); and *Exxon Corp. v. Middleton,* 613 S.W.2d 240 (Texas 1981).)

9. Market value is defined as the price at which the owner of the goods or the producer holds them for sale; the price at which they are freely offered in the market to all the world. (*Muser v. Magone,* 155 U. S. 240.) On the other hand, the regulated price for natural gas constitutes a utility rate which is designed to compensate the producer's actual cost of producing, gathering, transporting and marketing the natural gas, and afford it a fair return on its investment. (*Lightcap,* supra.) This rate does not purport to reflect the value of gas as determined in a market between willing buyers and sellers. (*Huber Corp. v. Denman,* 367 F.2d 104 (5th Cir. 1966).)

The fact that federal regulations restrict the price at which the lessee could have sold the gas in a free market should not change the meaning that a state court gives to "prevailing market rate" or the meaning that the parties undoubtedly gave to the term in 1936 and

1937 when the leases were made (long before the Natural Gas Act or the Natural Gas Policy Act). Neither should the regulated prices for sales constitute an artificial market for purposes of determining the lessor's royalty rights, since such rights are excluded from gas regulation. (*Mobil Oil Corp. v. Federal Power Commission,* 463 F.2d 256 (D. C. Cir. 1971), cert. denied, 406 U. S. 976, 92 S. Ct. 2409, 32 L. Ed. 2d 676; and FERC letter opinion of 8-2-79 attached, Appendix 3a.)

Petitioner would fashion a rule that modifies the contractual relation between the parties and would abrogate parties' express intention to the contrary. When the parties executed the leases in 1936 and 1937 neither reasonably foresaw federal regulation of natural gas prices. Presumably, their choice of a royalty clause based on the market rate or value of the gas anticipated a continuation of a market in which the price is determined by the law of supply and demand for the commodity and the highest and best prices paid in a particular area for comparable natural gas.

To hold as requested by Gulf would constitute judicial tampering with the clear provisions of the oil and gas lease contracts and would impose price ceilings on royalty payments - something never intended by Congress.

CONCLUSIONS

1. The Kansas Supreme Court has determined "prevailing market rate" to be the highest and best price paid producers for comparable natural gas in the Medicine Lodge area, at the time of production.

2. Gulf admits that oil and gas leases are to be interpreted according to state law and that royalty owners are not subject to FERC jurisdiction.

3. Federal law - the Natural Gas Policy Act - set ceiling prices that purchasers may pay producers - not ceilings on amounts that producers may pay their royalty owners.

4. Royalty owners have made no "sales" under NGPA. Sales contracts are between producers and gas purchasers, and royalties paid are only part of the costs of production. After the decision in *Mobil v. FPC,* supra, holding royalty owners not subject to FPC jurisdiction, Congress, in 1978, had it so intended, would have defined royalty owners subject to NGPA. It did not do so, and, as stated in FERC letter, Appendix 3a, royalty payments are a matter of state law.

5. Cases cited by Gulf are not authority for this court to interfere with contractual rights of royalty owners under oil and gas leases, as established by a State Supreme Court.

6. The Kansas Supreme Court's decision increases royalties payable from 1/8th or 2/16ths of proceeds of sale of gas to about 3/16ths, leaving Gulf or working interest owners about 13/16ths of total production.

7. The Kansas Supreme Court does not attempt to rule on NGPA or its effect but only on market value

of royalties payable under terms of Kansas oil and gas leases.

8. This case involves interpretation and application to royalty payments of a rather unusual phrase "prevailing market rate," in a few old, Barber County, Kansas, oil and gas leases.

9. NGPA does not attempt to control percentage of proceeds of sale of natural gas payable by a producer to its royalty owners.

10. This Court should not tamper with plain, simple and specific terms of oil and gas lease contracts and attempt to increase Gulf's profits by imposing ceilings on its royalty obligations.

11. The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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Attorneys for Respondents

February, 1984

APPENDIX

EXCERPTS FROM KANSAS SUPREME COURT OPINION - REASONS FOR AFFIRMING TRIAL COURT'S DECISION

". . . the basic question is the propriety of the trial court's interpretation of the phrase in the leases 'prevailing market rate.'" (Pet. Appendix 4a.)

"In. . . *Lightcap v. Mobil Oil Corporation,* 221 Kan. 448, 562 P.2d 1, cert. denied 434 U. S. 876 (1977) gas royalties to be calculated on the basis of market value or market price at the well, refers to value or price at the current market rate prevailing when the gas is delivered rather than the proceeds or amount realized under a gas purchase contract. . . The court stated market value or price could exceed the amount fixed by federal regulations under the Natural Gas Act of 1938. (15 U.S.C. Section 717 et seq.)" (Pet. Appendix 6a.)

"As he testified at trial Myers (a consulting petroleum engineer and expert witness for the lessors) believed the highest price being paid for gas in Kansas after enactment of the NGPA was the NGPA Section 108 (stripper well) price. 15 U.S.C. Section 3318." (Pet. Appendix 8a.)

"More important, however, is the principle of *Lightcap* that market value is the issue, irrespective of whether the sale is interstate or intrastate. See 3A Summers, *The Law of Oil & Gas,* Section 589 (1983 Supplement)." (Petition Appendix 8a.)

"The second determination pertained to the period after 1978 when intrastate gas became subject to federal regulation. Since there were no unregulated sales at the

time that determination was based on the highest regulated price for comparable natural gas in Barber County." (Pet. Appendix 10a.)

"Here the trial court relied on evidence of 'comparable sales' as the basis of its decision. Comparable sales of gas are those comparable in time, quality, quantity and availability of marketing outlets." (Pet. Appendix 10a.)

"Thus, as we noted at the outset, our task is to determine whether the trial court's findings regarding market value and comparable sales are supported by substantial, competent evidence." (Pet. Appendix 11a.)

"Based on the testimony of Mr. Myers, it simply used the highest price paid for comparable gas in the area both before and after federal regulation of interstate gas. As noted above those prices were obtained from the Okmar contract prior to 1978 and the NGPA Section 108 price after 1978. In both instances Myers testified the product for sale was comparable as to physical quality and access to market." (Pet. Appendix 11a.)

"The lessee thus has the opportunity to protect itself through specific terminology in the lease. In the absence of any evidence of contrary intent of the parties, we conclude the lessors are entitled to royalties based on the market value of gas at the time of production." (Pet. Appendix 11a-12a.)

"Although the use of the NGPA Section 108 price may be confusing it is used merely as evidence the gas is worth more than the Section 105 price placed on it by the FERC. Just as they were not bound by the gas purchase price, royalty owners with a market value lease are not limited to the regulated price." (Pet. Appendix 12a.)

¶ 4,220 p.1

¶ 4,220 LETTER OPINION (OGC) - SECTION 2(21)
Alamo Petroleum Company
August 2, 1979

FEDERAL ENERGY REGULATORY COMMISSION

August 02, 1979

Mr. Paul F. Vandergriff
Vice President - Land
Alamo Petroleum Company
4925 Greenville Avenue
Dallas, Texas 75206

Dear Mr. Vandergriff:

This is in reply to your letter dated May 23, 1979, requesting the General Counsel's interpretation of certain provisions of the Natural Gas Policy Act of 1978 (NGPA).

You have asked questions concerning the payment of royalty interests in accordance with the terms of a gas balancing agreement and the provisions of the subject leases. The NGPA Title I pricing scheme applies only to "first sale" transactions and not to those royalty payments which do not involve a transfer of gas for value. *Thus, an interpretation of the agreements with respect to royalty payments would appear to be a matter of State law.*

I hope the foregoing is responsive to your questions. The views contained herein are mine and do not bind the Commission in any way.

Sincerely,

Robert R. Nordhaus
General Counsel